STATE OF CALIFORNIA

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March 3, 2004

VIA INTERNET

Dear Interested Party :

The Sales and Use Tax Department is proposing to revise Audit Manual Chapter 8 by incorporating the changes described below. The full text of the changes, displayed on the following pages, is provided for the convenience of interested parties who may wish to submit comments.

<u>The proposed changes are:</u>

AM Section 0802.70, *Analysis of Audit Findings*. Updated terminology from “reasonableness short test” to “reasonableness evaluation” to make terminology consistent with AM section 0803.15.

AM Section 0809.10, *80/80 Rule*.

- Made minor grammatical corrections and text additions.
- Moved text regarding election to report cold food sales “to go” as nontaxable to first bullet for clarity.
- Moved text from AM 0419.55, Exempt Sales of Food Products – The 80-80 Rule. The explanation of the 80/80 rule is no longer needed in AM chapter 4 now that restaurant audits have been added to AM chapter 8.
- Deleted carbonated and alcoholic beverages from the explanation of how tax applies to combination meals. Revised based on August 10, 2001, Headquarters Operations Manager memo determining that although cold food and a carbonated beverage was a meal, it isn’t served when ordered “to go.” Section 6359(e) provides that a combination package of hot and cold items is taxable – the section does not mention carbonated or alcoholic beverages.

AM Section 0810.25, *Shelf Test*. Updated terminology from “reasonableness short test” to “reasonableness evaluation” to make terminology consistent with AM section 0803.15.

AM Section 0810.30, *Observation (Site) Test*. Updated terminology from “reasonableness short test” to “reasonableness evaluation” to make terminology consistent with AM section 0803.15.

If you have any comments or suggestions *related solely to the proposed changes described above*, you may contact the Department at AM.RevisionSuggestions@boe.ca.gov, or you may submit your suggestions to:

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All comments regarding the proposed changes must be received by **May 3, 2004** in order to be considered by staff. Thank you for your consideration. I look forward to your comments and suggestions.

Sincerely,

Jeffrey L. McGuire
Tax Policy Division
Sales and Use Tax Department

JLM: llw

ANALYSIS OF AUDIT FINDINGS 0802.70

The information developed through procedures outlined in the preceding sections should be carefully documented and evaluated by the auditor and included as part of the audit report. If it is concluded that a tax deficiency greater than the tolerance discussed in Section 0802.65 may exist, the auditor should proceed to establish the amount of the deficiency using generally accepted tax auditing procedures (e.g., the mark-up method of computing sales, an analysis of bank deposits, gross profit and net worth analysis, cash flow analysis, etc.).

When an audit approach other than the mark-up method is used, a post audit mark-up analysis should be performed to support the reasonableness of the audit findings. This is done by adding the amount of the deficiency to the reported sales and computing the mark-up percentage on the cost of sales.

Regardless of the audit procedures used by the auditor, if a tax deficiency has been established, an alternative method must be used and documented in the audit working papers to support the reasonableness of the audit findings. This is generally referred to as a reasonableness ~~short test~~evaluation. Alternative methods for supporting audit findings may include an analysis of the taxpayer's net income (Section 0803.15), cash flow analysis, analysis of bank deposits (Section 0405.25), and gross profit and net worth analysis (0406.40), etc.

80/80 RULE 0809.10

The application of tax to a restaurant's sales of cold food on a "take-out" or "to-go" order will generally depend on whether the establishment qualifies under the 80/80 rule ~~(~~[as provided by Regulation 1603(c)(3)~~)~~]. If the taxpayer operates multiple locations or more than one type of food operation, each individual location must be considered separately in determining if that location meets the specified criteria. However, combination locations such as a restaurant-bakery or food court location may be considered one operation for purposes of applying the 80/80 rule. Before applying the 80/80 rule, the auditor must first determine if:

More than 80% of the business' gross receipts are from the sale of food products (note: although the sales of alcohol and carbonated beverage are subject to tax, alcohol and carbonated beverages are not considered food products); ***and***

More than 80% of the retail sale of food products are taxable because they constitute:

- Sales of food products that are furnished, prepared, or served for consumption at facilities provided by the taxpayer;
- Sales of meals or hot prepared food products; or
- Sales of food products by a "drive-in" (food products sold for immediate consumption at or near a location~~,~~ at which parking facilities are provided primarily for the use of the patrons in consuming the products, even though they may be sold to go).

If a business meets both criteria of the 80/80 rule, the sales of cold food on a "to-go" or "take-out" basis, in a form suitable for consumption on the seller's premises, are subject to tax. However, with supporting documentation such as cash register receipts or sales tickets, the following exceptions may apply:

- <u>The taxpayer may elect to separately account for sales of cold food sold on a "to-go" or "take-out" basis. The sales must be separately accounted for and substantiated by supporting documentation. Without adequate documentation, tax applies to the gross receipts with no deduction for these items.</u>
- Cold food sold in a form *not* suitable for consumption on the premises. A cold food product is not "suitable for consumption on the premises" if it requires further processing by the purchaser, or it is sold in a size not ordinarily consumed by one person. In general, containers larger in size than a pint (excluding milkshakes and similar milk products) are considered to be in a form not suitable for immediate consumption.
- ~~Effective April 1, 1996, the taxpayer may elect to separately account for sales of cold food sold on a "to-go" or "take-out" basis. The sales must be separately accounted for and substantiated by supporting documentation. Without adequate documentation, tax applies to the gross receipts with no deduction for these items.~~
- Sales for resale, exempt, or excluded sales, such as to the U.S. Government.

When evaluating sales under the 80/80 rule, a test period of 90 days is recommended. However, a lesser period of time is appropriate if the business activity appears to have little fluctuation from month to month. The auditor should make comments in the audit working papers detailing which periods were selected to test and why the period was representative of the taxpayer's business operations.

<u>If the test of current sales does not meet the 80-80 criteria, but falls in the range of</u>

75%-80%, the taxpayer should be advised to periodically test sales to insure that the 80-80 criteria is not exceeded, and to apply tax prospectively if the criteria is exceeded. The taxpayer must document and retain the results of any tests performed.

Example - Test for the 80-80 rule:

Hot prepared food products	$ 85,000
Cold food products (sold in a form suitable for consumption on the seller's premises):	
Sold to-go	5,000
Sold for consumption on seller's premises	4,000
Nonfood Sales (alcohol and carbonated beverages)	6,000
Total Sales	$100,000

In the above example, over 80 percent of the taxpayer's sales are food sales ([$85,000 + $5,000 + $4,000] / $100,000 = 94%), and over 80% of the food sales are taxable ([$85,000 + $4,000] / [$85,000 + $5,000 + $4,000] = 95%). Do not include alcoholic and carbonated beverages as part of the food product sales. Although their sales are subject to tax, alcoholic and carbonated beverages are not food products. Similarly, food which is furnished in a form **not** suitable for consumption on the seller's premises should not be included in the computation. These foods will not become taxable even if the retailer meets the 80-80 criteria, and include such foods as:

Items not ordinarily consumed because they require further processing, cutting or assembly such as:

- a whole cold chicken
- party trays of meats and cheeses
- hors d'oeuvres prepared and sold to go

Food products typically altered before being consumed

- a dozen dinner rolls (will be assembled with a meal, cut and buttered)
- a whole pie or cake (will be cut into individual portions)

Container size ordinarily not immediately consumed by one person (obviously has more than one serving, and must be subdivided before serving)

- one quart of salad
- one quart of ice cream
- bottled ice cream toppings
- a loaf of bread
- a bottle of barbecue sauce

~~For that business not meeting~~Whether or not the business meets both criteria for the 80/80 rule, sales of hot prepared food products are subject to tax, including hot prepared food sold on a "to-go" or "take-out" basis. A food product is considered a hot food product if it is heated to a temperature above room temperature. A sale of hot prepared food is taxable even if it has cooled by the time of sale since it was intended to be sold as hot food.

Proposed Audit Manual Revisions

The application of tax to the sale of a cold food product depends on the form in which it is sold and where it is to be consumed. ~~Notwithstanding the application of~~When the 80/80 rule does not apply, sales of cold food sold on a "take-out" or "to-go" basis are exempt from tax. However, a sale of a combination of hot and cold foods for a single price is subject to tax. A combination package is two or more items sold together for a single price. The sale of a combination package is taxable if it includes any of the following items:

- A hot prepared food (such as a hot sandwich or hot bakery item)
- A hot beverage (such as coffee, hot chocolate, or tea)
- ~~A carbonated beverage (such as a soda or sparkling water)~~
- ~~An alcoholic beverage~~

If a combination package sold "to-go" does not include ~~one of the items listed above~~a hot item, it is not taxable (for example a cold sandwich and milk sold together for a single price). All carbonated and alcoholic beverages are taxable, whether sold "to-go" or for consumption on the taxpayer's premises. If a combination package of a cold food item and a carbonated beverage are sold "to-go" only the sale of the carbonated beverage is taxable. Carbonated beverages include sparkling mineral water and soft drinks.

If a combination of cold food products is sold in an individual ***returnable*** container, from which the individual serving is intended to be eaten, the sale is subject to tax. The sale is considered a sale of a served meal, which is generally taxable.

For a newly established business, the taxpayer should estimate the percentage of taxable food product sales. If the estimated percentage is less than 80%, records should be maintained detailing the nontaxable sales of food products, and at the end of 90 days the actual percentage should be calculated. If the resulting percentage meets the 80/80 rule criteria for two consecutive quarters, tax will be due on a prospective basis unless sales are separately accounted for by the taxpayer. If the resulting percentage does not meet the criteria, the taxpayer should verify quarterly that the 80/80 rule criteria has not yet been met. The quarterly test of taxable sales should be performed on a continuous basis or until it has been determined the taxpayer meets the criteria for two consecutive quarters. Once the taxable sales meet the established criteria for two consecutive quarters, tax would be due on a prospective basis. Furthermore, once the criteria has been met, the sales remain subject to tax unless there is a significant change in the business operations, or unless the taxpayer elects to separately account for the sales and retains the proper documentation.

SHELF TEST 0810.25

A shelf test is performed to assist the auditor in analyzing the taxpayer's achieved mark-up percentage(s) on recorded sales and/or to develop a weighted markup to establish total sales when the auditor feels that the achieved mark-up percentages are not reasonable (i.e., too low). The auditor should discuss the test in detail with the taxpayer and request the taxpayer's assistance in costing out menu items. The auditor should start by costing out the items that the restaurant sells most (the most popular dishes) including "plate cost" items such as the vegetable, butter, baked potato, and sauces. The most popular dishes may be determined from a discussion with the taxpayer and a review of the quantity of purchases for the primary ingredients. The quantity and ingredients should be obtained for each serving from the taxpayer. The auditor should note the total volume/weight of the ingredients to ensure reasonableness. The quantity of ingredients should be scheduled, with the cost of each derived from purchase invoices. The total cost of an item should be carried forward to a schedule summarizing all menu items in the test. The mark-up percentages should be computed on an individual and aggregate basis to examine consistency. Exhibit 14 provides an example of how to cost out a menu item.

When the use of the mark-up method is impractical, the auditor may establish sales using other generally accepted tax auditing procedures such as, but not limited to, the observation test (0810.30), bank deposit reconciliation (0810.10), or the credit card projection of sales (0810.12). When an audit approach other than the mark-up method is used, a post audit mark-up analysis should be performed to support the reasonableness of the audit findings. Regardless of the audit procedures used by the auditor, if a tax deficiency has been established, an alternative method must be used and documented in the audit working papers to support the reasonableness of the audit findings (i.e., a reasonableness ~~short test~~evaluation). Alternative methods for supporting audit findings may include an analysis of the taxpayer's net income (0803.15), analysis of bank deposits (0810.10, 0405.25), credit card projection of sales, or a gross profit and net worth analysis (0406.40).

The results of the test should be reconciled to the taxpayer's records for the day of the test. If differences were noted, the differences should be analyzed and discussed with the taxpayer. The results of the observation test should be extrapolated for a period of time, generally a year, and compared to reported/recorded amounts. However, if the taxpayer's records are not available for a representative period, the percentage of error developed in the test period may be projected to the remainder of the audit period. Consideration should be given to the seasonal nature of the business (if applicable) and any other relevant factors should be clearly explained in the audit working papers.

If a tax deficiency has been established using the observation test, an alternative method must be used and documented in the audit working papers to support the reasonableness of the audit findings (i.e., a reasonableness ~~short test~~evaluation).